IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1961

No. 657

KENTUCKY HOME MUTUAL LIFE INSURANCE COMPANY, Petitioner,

vs.

UNITED STATES OF AMERICA, Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

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INDEX.

	PAGE
Opinions Below	1
Jurisdiction	2
Questions Presented	2
Statute Involved	5
Statement of the Case	5
Reasons for Granting the Writ	9
1. The Court of Appeals has defined "interest" and "gross income" in a manner which offends the applicable statutory language and has been disapproved by this Court	9
2. The Court of Appeals, by disregarding the record and deciding the case on a non-existent state of facts, has departed drastically from the accepted and usual course of judicial proceedings	15
3. The Court of Appeals, by inferring the payment of interest from the terminology used in the reinsurance agreement and from the taxpayer's bookkeeping methods, rather than determining tax incidence on the basis of the substance of the transaction, has repudiated principles repeatedly approved by other Courts of Appeals and by this Court	19
4. The ruling of the Court of Appeals, if logically applied in other cases, would render taxable many types of transactions never before thought to involve receipt of income	22
5. The judgment of the Court of Appeals, in setting aside the District Court's finding without holding it to be clearly erroneous, conflicts with decisions of other Courts of Appeals	22

PAGE

Summary and Conclusion 26

Appendix A:

Memorandum, Findings of Fact, and Conclusions of Law of the District Court 29

Appendix B:

Opinions of the Court of Appeals 36

Appendix C:

Judgment of the Court of Appeals 45

CITATIONS.

Cases:

	PAGE
Arthur R. Jones Syndicate v. *Commissioner*, 23 F. 2d 833 (C.C.A. 7, 1927)	20
Bartels v. *Birmingham*, 332 U. S. 126 (1947)	20
Bowersock Mills & Power Co. v. *Commissioner*, 172 F. 2d 904 (C.A. 10, 1949)	20
Burnet v. *Wells*, 289 U. S. 670 (1933)	13
Central Railway Signal Co., Inc. v. *Longden*, 194 F. 2d 310 (C.A. 7, 1952)	25
Commissioner v. *Hansen*, 360 U. S. 446 (1959)	19
Commissioner v. *Jacobson*, 336 U. S. 28 (1949)	13
Commissioner v. *Proctor Shop, Inc.*, 82 F. 2d 792 (C.C.A. 9, 1936)	20
Deputy v. *duPont*, 308 U. S. 488 (1940)	12
Douglas v. *Willcuts*, 296 U. S. 1 (1935)	13
Doyle v. *Mitchell Bros. Co.*, 247 U. S. 179 (1918)	21
Equitable Life Assurance Society v. *Commissioner*, 321 U. S. 560 (1944)	10, 20, 24
John Kelley Co. v. *Commissioner*, 326 U. S. 521 (1946)	10, 12, 20, 24
Northwestern States Portland Cement Co. v. *Huston*, 126 F. 2d 196 (C.C.A. 8, 1942)	20
Old Colony R. Co. v. *Commissioner*, 284 U. S. 552 (1932)	11
Pleason v. *Commissioner*, 226 F. 2d 732 (C.A. 7, 1955), cert. den. 350 U. S. 1006 (1956)	25
Welp v. *United States*, 201 F. 2d 128 (C.A. 8, 1953)	21
Wilbur Security Co. v. *Commissioner*, 279 F. 2d 657 (C.A. 9, 1960)	24
Willett v. *Commissioner*, 277 F. 2d 586 (C.A. 6, 1960), cert. den. 364 U. S. 914 (1960)	23, 24, 25

Statutes and Rules:

PAGE

Internal Revenue Code of 1939 (26 U.S.C., 1952 ed.):
§ 22(a) 12, 13
§ 201(c)(1) 5, 9

United States Code:
Title 26, §7482(a) 24
Title 28, §1254 2
Title 28, §1346(a)(1) 8

Federal Rules of Civil Procedure:
F.R.C.P. 52(a) 4, 23

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UNITED STATES OF AMERICA, - - *Respondent.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

Kentucky Home Mutual Life Insurance Company prays that a writ of certiorari issue to review the judgment entered in this case on July 11, 1961, by the United States Court of Appeals for the Sixth Circuit, which reversed the judgment of the District Court of the United States for the Western District of Kentucky entered September 16, 1959.

OPINIONS BELOW.

The Memorandum, Findings of Fact, and Conclusions of Law of the District Court (R. 77-84), printed in Appendix A, *infra*, are reported at 176 Fed. Supp. 649. The opinions of the Court of Appeals (R. 145-152), printed in Appendix B, *infra*, are reported at 292 F. 2d 39.

JURISDICTION.

The judgment of the Court of Appeals, printed in Appendix C, was entered on July 11, 1961 (R. 143). A petition for rehearing was denied October 18, 1961 (R. 215). The jurisdiction of this Court is invoked under section 1254 of Title 28 of the United States Code.

QUESTIONS PRESENTED.

In 1932 the taxpayer, a newly organized life insurance company, partially reinsured the policy obligations of Inter-Southern Life Insurance Company (herein called "Inter-Southern"), which had become insolvent. The non-reinsured portion of each policy was fixed at 60% of its policy reserve* at that time, with provision for annual percentage increase of the said 60% impairment. For purposes of the reinsurance agreement, the 60% impairment was called a "lien" on the policy and the agreed annual adjustment of the impairment was called "interest."

The reinsurance agreement as amended in 1939 provides (Par. 4) that in the settlement of all reinsured Inter-Southern policies, the taxpayer shall pay the difference between the amount which Inter-Southern had contracted to pay on such settlement, and the amount of the so-called "lien" and accumulated so-called "interest" thereon. The reinsured policyholder was not required to pay the "lien" and "interest";

*Ordinarily, the policy reserve is the virtual equivalent of the policy's cash value. (The face value, payable on death, is of course much larger.)

but he could pay all or any part of either, in which event the impairment of his policy would be reduced by that amount and the amount payable by the taxpayer in such settlement would be correspondingly increased.

In 1952 the taxpayer received from policyholders cash payments in the amount of $6,731.26 in reduction of the amounts by which the original 60% impairment had been adjusted upward since 1932. In the same year the taxpayer made policy settlements in which the policyholders received less than would have been payable by the original insurer in accordance with the terms of its policies, the amount of the diminution being (a) the 60% impairment plus (b) adjustments, as aforesaid, in the amount of $61,271.38.

(1) The primary question here presented is whether the said $6,731.26 and $61,271.38 constitute taxable interest income to the reinsurer.

Subsumed under this question are the further more specific questions:

(a) Can the special statutory definition of "gross income" of life insurance companies—"interest, dividends and rents" *only*—be interpreted to include receipts and adjustments which are neither interest, nor dividends, nor rents?

(b) Are the income tax consequences of such receipts and adjustments controlled by the fact that they are referred to as "interest" in the 1932 reinsurance agreement pursuant to which they were made, rather than by their actual substance and effect?

(c) Can such receipts and adjustments be taxed as interest income because the taxpayer, for accounting purposes, has analogized them to interest accruals and payments on actual policy loans and used similar bookkeeping mechanics in entering them on its books?

(d) Does the effect of such receipts and adjustments bear any material resemblance to the economic effect of interest accruals and payments on actual policy loans?

The petitioner taxpayer contends that each of the above questions must be answered in the negative and that the Court of Appeals, by answering them in the affirmative, has indulged in a dangerous departure from accepted principles which, unless reversed, will broadly and adversely affect not only all life insurance companies, but business taxpayers generally.

(2) A second question is whether Rule 52(a) of the Rules of Civil Procedure precludes a Court of Appeals, in the absence of clear error, from setting aside the finding of a District Court as to the ultimate fact to be inferred from established evidentiary facts—here, the question whether the aforesaid payments and adjustments constituted interest income or whether they merely reflected and determined the contract liability of the taxpayer on settlements of reinsured Inter-Southern policies. On this issue, there is a conflict of decision between Courts of Appeals of the Sixth and other Circuits, and even within the Sixth Circuit itself.

STATUTE INVOLVED.

The case involves the interpretation of §201(c)(1) of the Internal Revenue Code of 1939, as amended by §163(a) of the Revenue Act of 1942, c. 619, 56 Stat. 798, 26 U.S.C. (1952 ed.), §201(c)(1), which provides in pertinent part:

> "(c) *Other Definitions.*—In the case of a life insurance company—
>
> "(1) *Gross income.*—The term 'gross income' means the gross amount of income received during the taxable year from interest, dividends, and rents."

STATEMENT OF THE CASE.

Inter-Southern, a Kentucky corporation with its principal office in Louisville, was placed in receivership by the Kentucky Insurance Commissioner on April 8, 1932. At that time the required statutory reserves on its thousands of outstanding insurance policies—which included ordinary life policies, endowment policies, disability policies, and pension and annuity contracts—exceeded its assets by more than $7,000,000.

The liquidation of Inter-Southern would not only have exposed its policyholders to losses incident to forced sale of assets during a time of deep economic depression, but would have done special and irreparable harm to such of them as had become uninsurable and thus disabled to obtain new insurance. The Kentucky Insurance Commissioner and the Receivers therefore

exerted themselves to work out a plan whereby Inter-Southern's business could be continued.

To this end a new corporation was organized under the name of Kentucky Home Life Insurance Company which, as reorganized on the mutual plan in 1935, is the petitioner taxpayer (and which is herein referred to as "Kentucky"). On August 8, 1932, with the approval of the receivership court and the Insurance Commissioner, a detailed reinsurance agreement was entered into by Inter-Southern and Kentucky.

The 1932 reinsurance agreement (R. 14-35; App'x 10a-31a),* as amended in 1935 and 1939 (R. 37-54; App'x 33a-50a), was in effect in 1952 (the tax year here involved). The so-called "interest" payments and adjustments which have occasioned the disputed tax were made pursuant to the said agreement. The agreement set forth the terms and conditions on which, ***and the extent to which,*** Kentucky would pay Inter-Southern's obligations on its outstanding policies.†

The agreement provided that Kentucky would take over all of Inter-Southern's assets. But inasmuch as those assets had been depleted to the point where they were worth less than the required reserves on the out-

*Pursuant to Rule 21(4), petitioner has filed nine copies of the record as printed for the use of the Court of Appeals, consisting of the appendices attached to the briefs of the respective parties. The pages of the appendix of respondent (appellant below) are numbered with the suffix "a", and the pages of the appendix of petitioner (appellee below) are numbered with the suffix "b". Thus, the above reference is to pages 14-35 of the certified record and pages 10a-31a of respondent's appendix as filed in the Court of Appeals and in this Court.

†For simplicity, the term "policies" is herein used to include annuity and pension contracts as well as insurance policies in the strict sense.

standing Inter-Southern policies, Kentucky could not assume Inter-Southern's policy obligations in full. Had it done so, it would have automatically rendered itself virtually as insolvent as Inter-Southern; *and as time went on it would have become still further insolvent, because the normal increase in the required policy reserves would not have been covered by investment income from the missing reserve assets.* Kentucky's reinsurance obligation on each policy was therefore stipulated to be the Inter-Southern obligation less the sum of (a) an amount equal to 60% of the policy reserve as of June 30, 1932, and (b) an adjustment equal to an agreed percentage* of said 60%—compounded annually for the period beginning June 30, 1932, and ending on the effective date of final policy settlement or when the policyholder restored the missing 60% as so adjusted, whichever first occurred (R. 15-17, 38-40; App'x 11a-13a, 34a-36a).

The issue here presented is whether the said percentage increase in the amount by which Kentucky's *reinsurance* obligation was stipulated to fall short of Inter-Southern's *original* obligation, is taxable as interest income. On the assumption that it is so taxable, taxes in the amount of $16,562.72 were assessed against Kentucky and paid by it, together with interest thereon in the amount of $2,241.27, making a total of

*The 1932 agreement provided that the annual percentage increase of the policy impairment would be 6%, and that the impairment would apply only to policy loans and pre-death cash settlements (R. 15, 17; App'x 11a, 13a). In 1939 the percentage was reduced to 5% and the impairment was extended to death claims, which the 1932 agreement had exempted therefrom (R. 39, 40; App'x 35a, 36a).

$18,803.99. A civil action to recover this amount, plus interest from the date of payment, was successful in the District Court (that Court having jurisdiction under 28 U.S.C. §1346(a)(1)); but the judgment of the District Court was reversed by the Court of Appeals, which directed entry of judgment for the respondent.

Kentucky's position, upheld by the District Court (whose carefully reasoned findings and conclusions are set forth in Appendix A) is that the annual percentage adjustment of the impairment of the Inter-Southern policies is not interest and cannot lawfully—or, indeed, constitutionally—be regarded as income. In no sense is it payment for the use of borrowed money. Nor can it be said that the agreed percentage increase in the measure of the impairment has relieved Kentucky of any legal obligation it ever assumed, since it did not reinsure Inter-Southern's full policy obligations.

The position of the tax authorities, embraced by the Court of Appeals (whose two opinions are set forth in Appendix B) is that the receipts and adjustments here in question were interest income (a) because, so it is claimed, their collateral economic effect was similar in some respects to the economic effect of interest payments and accruals on policy loans; (b) because the reinsurance agreement analogized them to interest by calling the 60% policy-impairment a "lien" and by using the term "interest" to describe the annual adjustment of that impairment; and (c) because, for accounting purposes, Kentucky handled them by use of the same bookkeeping mechanics as were used for interest on policy loans.

REASONS FOR GRANTING THE WRIT.

1. The Court of Appeals has defined "interest" and "gross income" in a manner which offends the applicable statutory language and has been disapproved by this Court.

The respondent and the Court of Appeals have placed great emphasis on a point which seems wholly and plainly immaterial. They demonstrate, in painstaking detail, that the $6,731.26 received in cash by Kentucky in 1952 was a thing of value. So it was. So would have been a like amount paid in premiums, or on loan principal repayments, or contributed to capital, or received as a gift. Any cash receipt is, in a sense, beneficial in and of itself.

The tax, however, is not on *receipts* but on *income*—which, in the case of insurance companies, is defined to mean "*interest* [compensation for use of borrowed money], *dividends* [distributions of corporate earnings] and *rents* [payment for use of property, other than money]." Since no one suggests that the receipts and adjustments here in question were dividends or rents, they are taxable only if they can rightly be called interest.

The concept of "interest" is a simple one, and until now its interpretation has occasioned relatively little litigation. In a nutshell, interest is nothing but payment for the use of borrowed money. The Commissioner of Internal Revenue has not even deemed it necessary to issue regulations clarifying the meaning of the term as used in Section 201(c)(1) of the Inter-

nal Revenue Code. This Court has referred to it as a term which, "as used in the tax statutes * * * need[s] no further definition * * *." *John Kelley Co. v. Commissioner*, 326 U. S. 521, 530 (1946). Such litigation as there has been has resulted mainly from efforts by taxpayers to disguise interest received by labeling it as something else, or to claim interest deductions by reason of payments not made for the use of borrowed money. And the courts have uniformly rejected such efforts, holding that incidence of income taxes is determined by business realities rather than semantics.

For example, in *Equitable Life Assurance Society v. Commissioner*, 321 U. S. 560, 564 (1944), this Court unanimously rejected a contention that "excess interest dividends" paid by a life insurance company were deductible by it as interest, saying:

> "The 'usual import' of the word interest is 'the amount which one has contracted to pay for the use of borrowed money.' *Old Colony R. Co. v. Commissioner*, 284 U. S. 552, 560; *Deputy v. Du Pont*, 308 U. S. 488, 498. We cannot say as a matter of law that the excess interest dividends fall within that category. They appear to be amounts which may be declared or withheld at the pleasure of the board of directors."

This is not the first time that the zeal of the tax authorities has led them to propose a strained and artificial definition of "interest" as a means of enlarging income tax liability beyond the limits fixed by Congress. But this Court has repeatedly and firmly re-

jected such proposals, holding that the statutory term must be interpreted in its generally understood meaning. Thus, in *Old Colony R. Co. v. Commissioner*, 284 U. S. 552, 560, 561 (1932), the Court said:

> "As was said in *Lynch v. Alworth-Stephens Co.*, 267 U. S. 364, 370, 'the plain, obvious and rational meaning of a statute is always to be preferred to any curious, narrow, hidden sense that nothing but the exigency of a hard case and the ingenuity and study of an acute and powerful intellect would discover.' This rule is applied to taxing acts: *DeGanay v. Lederer*, 250 U. S. 376, 381.
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> * * * * * * *
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> "And as respects 'interest,' the usual import of the term is the amount which one has contracted to pay for the use of borrowed money.
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> * * * * * * *
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> "We cannot believe that Congress used the word having in mind any concept other than the usual, ordinary and everyday meaning of the term, or that it was acquainted with the accountant's phrase 'effective rate' of interest and intended that as the measure of the permitted deduction.
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> * * * * * * *
>
> "In short, we think that in the common understanding 'interest' means what is usually called interest by those who pay and those who receive the amount so denominated in bond and coupon, and that the words of the statute permit the deduction of that sum, *and do not refer to some esoteric concept derived from subtle and theoretic analysis.*" (Emphasis added.)

To the same effect, see *Deputy* v. *duPont*, 308 U. S. 488, 497-498 (1940).

As has been noted, the special statutory scheme for taxing the income of life insurance companies involves a strictly delimited definition of "gross income" which must be respected if the Congressional purpose is to prevail. Receipts such as premium payments, which might be held to constitute income under the vaguer and more sweeping definition applied to other taxpayers, are wholly non-taxable. It is therefore of particular importance to ascertain whether the disputed items fall fairly within one of the three specific statutory categories.

The need for exact application of the statutory term "interest" is the same here as in the case of a deduction claimed for "interest" paid by the taxpayer. The taxpayer is not granted an interest deduction simply because his payment has constituted an "economic detriment" to him, or an "economic benefit" to the recipient; for that might be said of *any* kind of payment—dividends, capital transfers, gifts, etc. If it is *payment for the use of borrowed money* it is deductible as interest. Otherwise it is not. *John Kelley Co.* v. *Commissioner, supra.*

As a matter of fact, the "economic benefit" test, as applied by the Court of Appeals, would be plainly out of place even if Kentucky were not a life insurance company, so that its gross income would be measured by the broader definition contained in §22(a) of the

Internal Revenue Code of 1939.* The "economic benefit" test reflects the familiar principle that taxable income can be realized not only by reason of the actual receipt of cash or other property, but also by reason of relief from legal obligations. *Douglas* v. *Willcuts*, 296 U. S. 1 (1935); *Commissioner* v. *Jacobson*, 336 U. S. 28 (1949). To be sure, the doctrine has been extended, pursuant to express statutory mandate, to relief from "pressing social duty" not constituting a legal obligation. *Burnet* v. *Wells*, 289 U. S. 670 (1933) (payment of life insurance premiums by insurance trust held taxable income to insured settlor). But the principle can apply only where there is *some pre-existing obligation of the taxpayer from which he has been relieved.*

Kentucky had no obligation to Inter-Southern's policyholders, either legal or social or moral, except as stipulated in the agreement. Once it is understood that Kentucky's reinsurance obligation was a decreasing one, subject however to a power of the policyholder to prevent the decrease by making a pre-settlement cash payment—just as the holder of a decreasing term

*"22. *Gross income.*—*(a) General definition.*—'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, *or gains or profits and income derived from any source whatever.* (Emphasis added.) Internal Revenue Code of 1939, §22(a), as amended through 1952.

policy is often permitted to convert it into an ordinary life policy by making a cash payment sufficient to bring its reserve up to the requirement for a policy of that kind—the basic premise of the decision below is seen to be fallacious.

Fundamentally, what the Court of Appeals has done is to determine "economic effect" by comparing Kentucky's cash position with the position it would have had if it had *not* stipulated for the downward adjustments. But taxable "economic benefit" does not result from a taxpayer's *refusal* to assume a liability. Income results only from discharge of an actual existing liability which it *has* assumed.

By thus misapplying the "economic benefit" test and ignoring the statutory definition of life insurance company income, the Court of Appeals has rendered a decision which conflicts in principle with each of the several cases cited above. If the decision below is allowed to stand it is reasonable to expect that the courts will be flooded with claims by the tax authorities, and by taxpayers as well, that the existence or nonexistence of interest depends on a multitude of considerations wholly distinct from the simple question whether the payment in question is *compensation for the use of borrowed money.*

2. The Court of Appeals, by disregarding the record and deciding the case on a non-existent state of facts, has departed drastically from the accepted and usual course of judicial proceedings.

More is involved in this case than a simple error of law. The opinions of the Court of Appeals disclose a dismal failure on its part to understand the facts disclosed by the record. To be blunt, it has decided the case on an imagined state of facts. This is a matter of public importance and an occasion for general concern—particularly where the result is a warning to all taxpayers that, in drafting business documents, they can no longer assume that simple and heretofore well understood concepts will be held to carry their accepted meaning.

The opinion of Judge O'Sullivan contains this remarkable assertion (R. 147):

> "The reinsurance agreement did not reduce or wipe out any of the reserves that had been built up on the Inter-Southern policies. It subjected such reserves to the lien on such policies. A lien cannot be placed against something which has been wiped out or does not exist."

The Court of Appeals thus speaks of "the reserves that had been built up on the Inter-Southern policies" as if, in 1932, those reserves existed as real assets sufficient to cover the policy reserve *requirements*. The undisputed fact is that Inter-Southern's assets fell short of the legal requirements by 60%, or about

$7,000,000. The assets back of such reserves as had been "built up" had simply shrunk by 60% before Kentucky ever entered the picture—not an uncommon situation, incidentally, in the dark years of the early '30s. The quoted statement reveals that, incredible as it may seem, the Court of Appeals has confused legal reserve *requirements* with existing reserve *assets*.

Judge O'Sullivan goes on to say (R. 147-148):

> "*Kentucky re-insured the Inter-Southern policies in their respective full amounts,* collecting premiums chargeable for such amounts of insurance, but conditioning its obligation to pay such policies to [*sic*] its right to offset against the amount so payable the sixty percent lien, together with any accrued and unpaid interest on such lien." (Emphasis added.)

This statement is contrary to the explicit terms of the reinsurance agreement, Paragraph 2 of which provides (R. 14, 38; App'x 10a, 34a):

> "The Company [Kentucky] agrees * * * to, and does hereby, reinsure all the outstanding policies of insurance * * * issued * * * by the Inter-Southern which are in force, in accordance with the terms of said policies * * *, and, *subject to the exceptions, modifications and limitations herein stated,* agrees to, and does hereby, assume the liability thereunder * * *." (Emphasis added.)

One such limitation was the reduction described above, amounting to 60% of the then reserve plus annual per-

centage adjustments thereof (Par. 4). Kentucky, then a newly organized company, did not and obviously could not "reinsure the Inter-Southern policies in their respective full amounts." The Court of Appeals has evidently failed to grasp this basic business fact—a fact which, as shown above, is highly material to the question of "economic benefit."

Indeed, the Court has implicitly recognized the failure of Judge O'Sullivan's opinion to meet the true issues; for Judge Cecil has written a concurring opinion which attempts to shore up the O'Sullivan opinion with additional arguments. All three judges have concurred in *both* opinions, so that the "concurring" opinion is actually a supplemental opinion of the Court.

But the second opinion likewise departs from reality. It declares (R. 151):

> "Assume, for example, that in the taxable year in question the five-percent interest provided in the contract on the lien in a certain policy amounted to $300. If the policy holder did not pay that during the year, Kentucky could add that amount to the total of the then existing lien. It could then have drawn down $300 from the actual reserve on deposit with the Commissioner."

Nothing could be further from the fact. The $300 could not have been "drawn down" for the simple reason that there were no reserve assets behind it. The quoted passage not only reveals the same confusion between legal reserve *requirements* and existing reserve *assets* as is manifested in the first opinion; it also

shows that the Court has failed to appreciate the fact that the reserve requirement *grows as time passes.* The same lapse of time which would lead to the hypothesized $300 increase in the "lien" would also result in an increase in the reserve requirement, and the insurer—far from "drawing down" the $300—would actually have to add to the policy reserve.

While it may perhaps be said that risk of legal error by a Court of Appeals is a general hazard which all litigants must live with, we submit that any taxpayer is entitled to demand that the Court take the trouble to learn the facts on which he bases his claim, and adjudicate his case on those facts. Indeed, misconception of the record is the primary ground on which rehearing petitions can rightly be submitted.* Adherence by a Court of Appeals to a position founded on plain and material factual misconceptions is such a departure from the accepted and usual course of judicial proceedings as to call for an exercise of this Court's power of supervision.

*Petitioner's careful rehearing petition, in which the above errors were detailed (R. 157-183), was denied by the Court of Appeals without opinion (R. 215).

3. The Court of Appeals, by inferring the payment of interest from the terminology used in the reinsurance agreement and from the taxpayer's bookkeeping methods, rather than determining tax incidence on the basis of the substance of the transaction, has repudiated principles repeatedly approved by other Courts of Appeals and by this Court.

In addition to the "economic benefit" point, the opinion of Judge O'Sullivan (concurred in by the whole court) also says (R. 149, 150):

> "The evidence in this case showed that the interest paid or accrued upon the liens in question *was treated in Kentucky's statement of assets and liabilities* in the same manner and with the same effect as interest received upon loans made to its policy holders.
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> * * * * * * *
>
> "We * * * are of the opinion that the interest upon which the tax involved here was imposed *was what it was called by all parties involved*—interest—and was, therefore, subject to income tax as provided by the applicable statute." (Emphasis added.)

Nothing in the law of income taxation is better settled than the proposition that tax incidence is controlled by substance rather than form. As stated in *Commissioner* v. *Hansen*, 360 U. S. 446, 461-462 (1959):

> "We agree, of course, that the incidence of taxation depends upon the substance, not the form, of the transaction. *Commissioner* v. *Court Hold-*

ing Co., 324 U. S. 331, 334; *Helvering* v. *F. & R. Lazarus & Co.*, 308 U. S. 252, 255; *Bowers* v. *Kerbaugh-Empire Co.*, 271 U. S. 170, 174; *Weiss* v. *Stearn*, 265 U. S. 242, 254; *United States* v. *Phellis*, 257 U. S. 156, 168 * * *."

In this connection it would perhaps be enough to point out that in *Bartels* v. *Birmingham*, 332 U. S. 126 (1947) this Court, despite the absence of a decisional conflict, granted certiorari and reversed a judgment of the Eighth Circuit Court of Appeals holding that contractual designation of a person as an "employer" was not enough to render him taxable as such *even though the specific and deliberate purpose of the contract, which he signed, was to render him thus taxable.*

Both this Court and the Courts of Appeals have applied the principle that substance dominates form, in deciding whether payments can be characterized as "interest" for income tax purposes. See, *e. g.*, *Equitable Life Assurance Society* v. *Commissioner*, *supra*; *John Kelley Co.* v. *Commissioner*, *supra*; *Bowersock Mills & Power Co.* v. *Commissioner*, 172 F. 2d 904 (C.A. 10, 1949); *Commissioner* v. *Proctor Shop, Inc.*, 82 F. 2d 792 (C.C.A. 9, 1936); *Arthur R. Jones Syndicate* v. *Commissioner*, 23 F. 2d 833 (C.C.A. 7, 1927).

As said in *Northwestern States Portland Cement Co.* v. *Huston*, 126 F. 2d 196, 199 (C.C.A. 8, 1942):

> "Bookkeeping entries do not produce either income or losses for the purposes of taxation. They are intended to record facts, and are evidential, *but they do not create or destroy facts.*

> 'The bookkeeping creates nothing, and the question must be decided according to proven and established facts.' Sitterding v. Commissioner, 4 Cir. 80 F. 2d 939, 941. The decision in this case must rest not upon the bookkeeping methods employed by the taxpayer but upon the actual facts, which are not in dispute." (Emphasis added.)

The foregoing language was quoted with approval in *Welp* v. *United States*, 201 F. 2d 128, 131 (C.A. 8, 1953).

This Court, in *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179, 187 (1918), had this to say with reference to the weight to be given book entries where the book entries were at variance with the proven facts:

> "* * * Nor is the result altered by the mere fact that the increment of value had not been entered upon plaintiff's books of account. Such books are no more than evidential, being neither indispensable nor conclusive. The decision must rest upon the actual facts, which in the present case are not in dispute."

By attributing decisive effect to the form of the transaction rather than its substance, the ruling of the Court of Appeals in the present case conflicts in principle with each of these decisions, and with many others that could be cited to like effect.

4. The ruling of the Court of Appeals, if logically applied in other cases, would render taxable many types of transactions never before thought to involve receipt of income.

The "economic effect" rationale adopted by the Court of Appeals proves far too much. If an insurance company were taxable on any reduction of its obligation to policyholders, certain types of insurance would result in taxes never before dreamed of. For example, the so-called family income insurance, a form of decreasing term policy which guarantees periodic post-death payments until a fixed future date, would be held to yield interest to the insurer each year insured by the annual decrease in coverage. The same would be true of the familiar mortgage life insurance and other forms of credit insurance which provide for payment of the balance of a decreasing debt if the debtor dies. The consequences of the decision below, unless this Court takes jurisdiction and reverses, will be far-reaching indeed.

5. The judgment of the Court of Appeals, in setting aside the District Court's finding without holding it to be clearly erroneous, conflicts with decisions of other Courts of Appeals.

The District Court's Findings of Fact (Appendix A) include an ultimate finding (No. 6) inferred from the stipulated and established evidentiary facts. The finding is to the effect that the $6,731.26 paid in cash by policyholders in 1952 was in the nature of pay-

ment for additional insurance, and that the $61,271.28 of adjustments made in 1952 policy settlements represented, in effect, a portion of the insurance which the policyholders had themselves agreed to carry.

The Court of Appeals did not hold the said finding to be clearly erroneous but nevertheless set it aside and made its own finding that the said payments and adjustments constituted interest.

Rule 52(a) of the Rules of Civil Procedure provides that the findings of fact of a district court sitting without a jury "shall not be set aside unless clearly erroneous." There is a conflict between the Sixth and other circuits, and indeed *within* the Sixth Circuit, as to whether this rule applies to findings of ultimate fact inferred from established evidentiary facts. The conflict has more than once been explicitly acknowledged by the Sixth Circuit Court of Appeals itself. Thus, in *Willett v. Commissioner,* 277 F. 2d 586, 589-590 (C.A. 6, 1960), cert. den. 364 U. S. 914 (1960), the Court said:

> "After a careful reading of the entire record submitted by the petitioners and consideration of all the facts and circumstances in these cases we consider that there is ample evidence to support the Findings of Fact and the conclusions and inferences drawn therefrom. They are not clearly erroneous.
>
> "Counsel for the petitioners contend that the clearly erroneous rule is not applicable to conclusions drawn by the Trial Judge from undisputed facts.

> "In Commissioner of Internal Revenue v. Consolidated Premium Iron Ores, Limited, [265 F. 2d 320 (C.A. 6, 1959)] * * * it was pointed out by this Court that not only is there a conflict in the Circuits on this point but there are also conflicts on it within the Circuits. This is true in the Sixth Circuit. (See cases cited in the Consolidated Premium Iron Ores case.) On this question we adhere to the view expressed in the Consolidated Premium Iron Ores case."

The *Willett* case involved review of a decision of the Tax Court rather than the District Court; but the difference is an immaterial one (and was so regarded by the court) because 26 U. S. C. § 7482(a) provides that Tax Court decisions are reviewable "in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury".

The "clearly erroneous" rule has been applied both by this Court and by the Ninth Circuit Court of Appeals in cases involving the precise question whether payments were rightly characterized as "interest." *Equitable Life Assurance Society* v. *Commissioner, supra,* 321 U. S. at pp. 563-564; *John Kelley Co.* v. *Commissioner, supra,* 326 U. S. at pp. 526-527; *Wilbur Security Co.* v. *Commissioner,* 279 F. 2d 657 (C.A. 9, 1960). In the last-cited case the Court said (at pp. 658, 659):

> "The sole question is whether the above amounts paid by the taxpayer to certain individuals constituted dividends and not deductible interest.

> "Concededly, this is a question of fact. The determination of such question of fact by the Tax Court is conclusive on us, unless the conclusion is clearly erroneous. Fed. R. Civ. P. 52(a), 28 U.S.C.A. E.g. Earle v. W. J. Jones & Son, 9 Cir., 1952, 200 F. 2d 846.
>
> * * * * * * *
>
> "When two or more inferences can reasonably be deducted [*sic*] from the facts, the reviewing court is without power to substitute its deductions for those of the trial court. The rule is as applicable in reviewing the findings of a judge as it is when considering a jury's verdict. 26 U.S.C. §7482(a); Fed. R. Civ. P. 52(a). It is as applicable to petitions for review from the Tax Court as to ordinary appeals."

Other rulings which conflict with the decision below on this point are *Pleason* v. *Commissioner*, 226 F. 2d 732, 733 (C.A. 7, 1955), cert. den. 350 U. S. 1006 (1956); *Central Railway Signal Co., Inc.* v. *Longden*, 194 F. 2d 310 (C.A. 7, 1952).

What is fundamentally involved is the allocation and acceptance of judicial responsibility. Litigants are entitled to know whether primary responsibility for the adjudication of their cases rests with the trial court or the appellate court. In the *Willett* case, the Sixth Circuit Court of Appeals told the taxpayer that the trial court's finding, *adverse* to him, could not be disturbed on appeal because not clearly erroneous. In the present case the same court told the taxpayer (which, incidentally, was represented by the same counsel) that the trial court's finding, *favorable* to it,

was not binding though not found to be clearly erroneous. Considered together, the cases evidently hold that the taxpayer must lose either way—a position not calculated to enhance the stature of the Federal judiciary.

The question is one of continuing importance in the administration of the tax laws, and the decisional conflict should be resolved by this Court.

SUMMARY AND CONCLUSION.

The Court of Appeals has failed to grasp the central and essential point: that payments of "lien interest" represent simply an advance by the policyholder of funds *which Kentucky must eventually pay back to him in the form of policy proceeds.* Or if the policyholder has elected to pay nothing but his premiums, and thus to let the "lien" and "interest" be reflected in the final settlement of his policy, then the amount by which the policy proceeds fall short of what Inter-Southern agreed to pay represents nothing but the impairment of the policy as of August 8, 1932, *adjusted (as provided in the reinsurance agreement) to reflect the passage of time.*

The effect of the judgment below is to put the petitioner life insurance company in a position much worse than that enjoyed by other business taxpayers. An ordinary taxpayer at least gets a deduction for payment of obligations arising out of the receipt of taxable income. Petitioner, on the other hand, could claim no deduction for repayment to the policyholder of

"lien interest" paid to it in 1952, since such repayment took the form of additional policy proceeds.

The judgment of the Court of Appeals is not merely erroneous. It is contrary to the whole current of judicial decision, including considered rulings of this Court. It is heavily burdensome to this relatively small insurance company—for it must be recognized that the decision herein will control its liability not only for 1952 but for other years as well. The effect of the decision upon other taxpayers generally, and especially life insurance companies, is potentially disastrous. It is submitted that these circumstances justify the exercise of this Court's discretionary power to issue a writ of certiorari.

Respectfully submitted,

LOUIS LUSKY,
Attorney for Petitioner.

CHARLES I. DAWSON,
Of Counsel.

APPENDIX

APPENDIX A.

MEMORANDUM, FINDINGS OF FACT AND CONCLUSIONS OF LAW OF DISTRICT COURT OF THE UNITED STATES FOR THE WESTERN DISTRICT OF KENTUCKY.

MEMORANDUM.

The complaint in this action was filed by the Kentucky Home Mutual Life Insurance Company against the United States on March 5, 1957, seeking to recover $18,803.99, with interest from July 19, 1955, the amount of income tax alleged by plaintiff to have been erroneously assessed and collected for the calendar year 1952. The amount of the tax was $16,562.72, with interest of $2,241.27, paid July 21, 1955. The case was tried to the Court without a jury on May 13, 1959. The essential facts were stipulated by a written stipulation filed October 15, 1958, and the plaintiff introduced four witnesses at the trial.

The question is whether, under Section 201 of the Internal Revenue Code of 1939, deductions of liens and accumulated interest in final settlement of reinsured Inter-Southern policies result in taxable income to the reinsurer, Kentucky Home Mutual Life Insurance Company, and also whether payments in cash of interest installments on the liens, when paid by policyholders, constitute taxable income to the Kentucky Home Mutual Life Insurance Company in the year in which the accruing interest installments were paid.

FINDINGS OF FACT.

From the stipulated facts and the testimony of plaintiff's witnesses adduced at the trial, the Court makes the following findings of fact:

1. Inter-Southern Life Insurance Company was a Kentucky corporation engaged in the life insurance business. For some time prior to April 8, 1932, Inter-Southern had been and was on that date in failing financial condition. Whereupon, the Commissioner of Insurance of Kentucky filed an action in the Circuit Court of Franklin County, Kentucky, for the appointment of a receiver for the assets of that company and for other proper proceedings. In that action it was determined that Inter-Southern's liabilities exceeded its assets by more than $7,000,000.00 and temporary receivers were appointed. Subsequently, the appointment of the temporary receivers was made permanent and the company's business continued as limited in the court's order. All of the company's assets were taken in possession by the receivers.

2. August 8, 1932, the Franklin Circuit Court authorized the receivers to enter into a contract with the Kentucky Home Life Insurance Company, a Kentucky corporation, by the terms of which Kentucky Home Life and the receivers executed a reinsurance agreement which was approved by the Commissioner of Insurance of Kentucky and by proper orders of the Franklin Circuit Court.

3. Subsequently, on March 9, 1935, the Franklin Circuit Court, by its order, authorized Kentucky Home Life Insurance to reorganize as a mutual life insurance company under Kentucky law, and authorized the new company and the receivers to enter into an amended reinsurance agreement. Kentucky Home Life, under the authority granted to it, was reorganized as a mutual company and its name as reorganized became "Kentucky Home Mutual Life Insur-

ance Company," under which name it has continued and is engaged today.

March 16, 1935, after the Kentucky Home Mutual Life Insurance Company and the receivers of Inter-Southern had entered into the amended reinsurance agreement with the approval of the Commissioner of Insurance of Kentucky and the Franklin Circuit Court, the receivers were discharged, and since that date Kentucky Home Mutual Life Insurance Company has had and administered the business and assets of Inter-Southern.

4. September 18 1939, under order of the Franklin Circuit Court and with the approval of the Commissioner of Insurance of Kentucky, a second amended reinsurance agreement was entered into and the affairs of Inter-Southern have been administered by the Kentucky Home Mutual Life Insurance Company under the original reinsurance agreement as twice amended. The amendment of September 18, 1939 eliminated the provision contained in Paragraph 4 of the original reinsurance agreement that the lien and its accumulated interest should not be deducted in death settlements and provides that thereafter the lien and accumulated interest thereon should be deducted in all policy settlements, including death settlements.

5. Under the original reinsurance agreement, Kentucky Home Life assumed liability for all of the policies of Inter-Southern at face value less a lien in an amount equal to 60% of the net equity of the existing policies at the time of the original contract. Paragraph 4 of the original reinsurance agreement is as follows:

> "Whereas the assets of Inter-Southern hereby and to be hereafter conveyed to the Company are not sufficient at either their actual and/or agreed-on admitted value, as hereinafter stated, to provide for the discharge of the obligations hereby assumed, as part of the consideration there shall be established and placed

against each policy reinsured and assumed hereunder by the Company, a lien equal to sixty per cent (60%) of the net equity as hereinafter defined, such lien to bear interest from June 30, 1932, at the rate of six per cent (6%) per annum, compounded annually. The liens established herein shall be set up as an asset of the business reinsured hereunder. The term 'net equity' as applied to any policy, is hereby defined as the mean reserve on such policy and on any coupon additions or accumulations standing to the credit thereof as of June 30, 1932, less the sum of any indebtedness and accrued interest thereon to said date. Such mean reserve shall be computed on the basis established by the Inter-Southern for its last annual valuation. Both lien and interest thereon shall be deducted from any payment made by the Company pursuant to the terms of said policies or from any settlement thereunder, or from the value used to purchase any extended insurance, except as otherwise hereinafter provided; however, no deduction on account of such lien or interest shall be made from the amount payable on any death claim arising under any policy reinsured and/or assumed hereunder. All policies reinsured hereunder which are in force at the effective date of this agreement, or which may hereafter be in force as paid-up insurance shall be subject to the aforesaid lien. When the amount of any policy indebtedness and/or lien, with interest thereon, on such paid-up insurance equals or exceeds the reserve thereon, then such paid-up insurance shall cease and determine. All policies reinsured hereunder which are in force at the effective date of this agreement as extended insurance for a specified period, shall be treated as follows: The date of expiry of such extended insurance shall be changes [*sic*] so that the reserve therefor at the effective date of this agreement shall be forty per cent (40%) of the

reserve at said date for the then unexpired portion of the original period of extension. Such extended insurance shall be for an amount equal to the death benefit in force at the effective date of this agreement. When any reduction in liens is made effective, the expiry date of any policy still in force as extended or continued insurance at the effective date of such reduction, shall be further extended by application thereto of the share of said policy in said reduction. No such policy which shall have expired before the effective date of such reduction in lien shall have any participation by extension, credit, or otherwise, in such reduction."

6. It will be noted that a provision of the above paragraph is, "The liens established herein shall be set up as an asset of the business reinsured hereunder." The 60% lien of the net equity was to bear interest from June 30, 1932 at the rate of 6% per annum and this interest compounded annually. All of the policies were subject to the 60% lien, with the right to the policyholder to discharge the lien to Kentucky Home Mutual Life by payment of the amount of the lien plus any interest accrued and thereby be entitled to receive the full face amount of the policy as a death benefit, or he could surrender the policy and have the amount of the lien plus any accrued interest offset against the proceeds. The 60% lien under the reinsurance agreement, however, did not represent an obligation on the part of the policyholder to Kentucky Home Mutual Life. In effect, it represented that portion of the policy obligation of the Inter-Southern which the respective policyholder agreed himself to carry. Any payment which an Inter-Southern policy holder paid on the lien against his policy and the accumulated interest thereon automatically increased by that exact amount the amount which Kentucky Home Mutual Life was required to pay as a death benefit or

upon surrender of the policy for its loan or cash surrender value.

During the calendar year 1952, Kentucky Home Mutual Life deducted in policy settlements of Inter-Southern policies the amount of $61,271.28, representing the aggregate of accumulated interest on the liens on the policies in respect of which such settlements were made. In the taxable year 1952, the holders of reinsured Inter-Southern policies paid to the plaintiff $6,731.26 as interest accumulated on the lien against their respective policies.

The Court finds that neither the $61,271.28 deducted in policy settlements nor the $6,731.26 paid Kentucky Home Mutual Life as interest constituted income to Kentucky Home Mutual Life in the taxable year 1952.

7. It was stipulated that the Kentucky Home Mutual Life keeps its books and makes its federal income tax returns upon the calendar year basis, and that for the calendar year 1952 it filed its income tax return and paid the tax shown by that return to be due. In reporting its income for that year, it did not include as income the $61,271.28 deducted in policy settlement or the $6,731.26 interest paid by the Inter-Southern policyholders.

8. The Commissioner of Internal Revenue, upon an examination of Kentucky Home Mutual Life's 1952 income tax return, determined that the sums deducted in policy settlements and received as interest on liens both constituted income which had been erroneously omitted from the 1952 return. A deficiency in tax was assessed amounting to $16,562.27 [*sic* $16,562.72]. This amount was paid by Kentucky Home Mutual Life on July 21, 1955, at which time interest in the sum of $2,241.27 had accrued on the assessment, making an aggregate of $18,803.99.

9. December 23, 1955, Kentucky Home Mutual Life filed its claim for a refund of said tax and interest, which the authorities of the Internal Revenue Department declined to pay.

CONCLUSIONS OF LAW.

The Court makes the following conclusions of law:

1. This Court has jurisdiction of this action and of the parties. Title 28, Section 1346(a)(1), United States Code Annotated.

2. Section 201 of the Internal Revenue Code of 1939 defines income of a life insurance company as follows:

> "Gross income.—The term 'gross income' means the gross amount of income received during the taxable year from interest, dividends, and rents."

3. The assessment of income tax on the amount of $61,271.28 deducted in policy settlements in the year 1952 and on the amount of $6,731.26 interest on liens on Inter-Southern policies paid to Kentucky Home Mutual Life during the calendar year 1952 was erroneous.

4. The collection by the Internal Revenue Department of $18,803.99, representing the tax assessed and interest paid July 21, 1955, was wrongful and plaintiff is entitled to recover said sum with such interest thereon as may be allowed by law. An appropriate judgment in accordance with this conclusion will be submitted by counsel for plaintiff on notice, in accordance with the local rules of this Court.

/s/ Roy M. Shelbourne
Roy M. Shelbourne
United States District Judge

August 12, 1959

APPENDIX B.

OPINIONS OF UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

OPINION—Decided July 11, 1961;
Filed July 11, 1961.

Before McAllister, Cecil and O'Sullivan, Circuit Judges.

O'Sullivan, Circuit Judge. As the conclusion of receivership proceedings had in the Circuit Court of Franklin County, Kentucky, plaintiff-appellee, Kentucky Home Mutual Life Insurance Company, hereinafter referred to as Kentucky, took over all of the assets of the insolvent Inter-Southern Life Insurance Company, hereinafter referred to as Inter-Southern. Kentucky entered into a re-insurance agreement with Inter-Southern, its receivers and the Insurance Commissioner of the State of Kentucky, whereby Kentucky agreed to assume Inter-Southern's liability to its policy holders, subject to the conditions in the re-insurance agreement.

As finally amended on September 18, 1939, the re-insurance agreement provided that a lien be imposed upon each of the re-insured Inter-Southern policies to the extent of 60% of the 1932 equity, or reserve, of each of such policies. The amounts of the liens on the respective policies were, from and after August 18, 1932, to bear interest, payable to Kentucky at the rate of six percent per annum, compounded annually.[1]

[1]The rate of interest was reduced to 5% after September 30, 1939.

The re-insurance agreement provided that the Inter-Southern policy holders might pay off the amount of the lien in full or in part at any time, with a proportionate increase in the ultimate amount of insurance payable, and said policy holders could pay the interest as it accrued annually, or at any other time. If such policy holder did not pay the lien and the interest as it accrued, any unpaid balance of the lien and accrued interest was to be taken from any payment to the policy holder either as cash surrender value, a loan, or in final settlement on the death of the insured.

In the tax year of 1952, Kentucky Home Life Insurance Company received as interest paid on the aforesaid liens the sum of $6,731.86. It offset against death claims paid in that year $43,197.34, representing accrued interest upon the liens against the policies upon which the death claims were paid in that year. Accrued interest was also offset against coupons on death claims in the amount of $835.69. It offset $2,209.16 against maturities in that year. It offset $13,886.79 as accrued interest against cash surrenders, and the sum of $1,142.30 as accrued interest against coupons on cash surrenders. These items totalled $68,002.64.

Upon review of Kentucky's income tax return for 1952, the Commissioner assessed a deficiency of $16,652.27, being the tax payable on the said $68,002.64 interest so received, asserting that such amount was income received from interest, within the meaning of Section 201(c)(1) of the 1939 Internal Revenue Code. The taxpayer paid this amount, which with interest totalled $18,803.99, and upon denial of its claim for refund, brought suit to recover the amount paid in the District Court for the Western District of Kentucky. The district judge gave a judgment for the plaintiff taxpayer.

The applicable tax statute, in defining taxable income, provides in Section 201, as follows:

> "(c) Other Definitions—In the case of a life insurance company——
>
> (1) Gross Income—The term 'gross income' means the gross amount of income received during the taxable year from *interest*, dividends, and rents."

Kentucky contends that interest paid to it or accrued and offset against payments made by it in settlements on Inter-Southern policies in the tax year of 1952 was not "income received during the taxable year from interest" within the meaning of the tax statute.

In the receivership proceedings, it was found that the assets of Inter-Southern were so impaired that in order to set aside adequate reserves for the payment of the Inter-Southern policies as they matured, it was necessary to supplement such assets by the aforesaid liens against the reserve of each policy so reinsured. Pursuant to the re-insurance agreement, each lien was set up as an asset, thereby establishing reserves in the amounts required by the Insurance Commissioner of Kentucky; the liens were accepted by the Insurance Commissioner as assets to the extent of sixty percent of the reserves on the policies. By being given credit, as a deposit of assets with the Insurance Commissioner, for the sixty percent lien imposed upon each Inter-Southern policy, taxpayer was required to deposit securities and other assets (apart from the liens) only to the extent of forty percent of the legally required reserves. Thus, the deposit with Insurance Commissioner as needed reserves for all of the Inter-Southern policies consisted of policy liens to the extent of sixty percent and other assets for the additional forty percent.

By the terms of the re-insurance agreement, the Inter-Southern policy holders were permitted to pay off the

amount of the lien in full or in part at any time. The policy holder could also pay the interest as it accrued annually, or at any other time. Some policy holders did pay off the liens. Others paid the interest currently to prevent an increase in the amount which would be offset in any settlement of benefits payable upon the Inter-Southern policies. In addition to any interest payable on the liens, the policy holders were required to pay in full whatever premiums were payable upon the policies on the basis of their full face value.

The re-insurance agreement did not reduce or wipe out any of the reserves that had been built up on the Inter-Southern policies. It subjected such reserves to the liens on such policies. A lien cannot be placed against something which has been wiped out or does not exist. Kentucky re-insured the Inter-Southern policies in their respective full amounts, collecting premiums chargeable for such amounts of insurance, but conditioning its obligation to pay such policies to its right to offset against the amount so payable the sixty percent lien, together with any accrued and unpaid interest on such lien.

Taxpayer insists that it got no economic benefit from the interest earned upon the liens in question. We are unable, from the standpoint of economic benefit to Kentucky, to find any difference between the interest earned on these liens and the interest earned and realized on loans made by Kentucky to its policy holders. The obligation of a policy holder obtaining a loan upon his policy was an indebtedness repayable to the insurance company, with interest accruing on such indebtedness until it was paid. That obligation was secured by the reserve of the policy of the borrower. In the case of a re-insured policy holder of Inter-Southern, the lien imposed on his policy was identical in its impact on the benefits provided for him by his insurance contract with the consequences resulting to one

who had borrowed upon the security of a policy. Such lien, for all practical purposes, became an obligation secured by, and payable out of, any maturity value of his policy. The Court of Appeals of Kentucky, in the case of *Kentucky Home Life Ins. Co.* v. *Leisman*, 268 Ky. 825, in considering the re-insurance agreement now before us, at page 828 characterized these liens as loans:

> "The substantial effect of this agreement, of course, was to set up a pool by the policyholders to meet the liabilities of the Inter-Southern *by placing a loan against each policy.* . . ."

Each Inter-Southern policy holder who elected to continue as an insured by paying the full premium on his policy, in effect, became a party to the re-insurance agreement and accepted the lien obligation imposed. A lien is a charge or encumbrance upon property to secure the payment or performance of a debt, duty, or other obligation. *United States* v. *Phillips*, 267 F. (2) 374, 377 (C. A. 5, 1959).

The economic benefits flowing to Kentucky from the interest earned on policy loans or liens were, in our opinion, identical. The Kentucky statute requiring the deposit of assets with the Insurance Commissioner to protect policy reserves treated money loaned on policies in the same manner as the liens involved here. KRS 304.832, in defining the assets needed to be deposited to protect reserve deficiencies and what assets were required to be deposited, says:

> ". . . . less any sums that it has advanced from its legal reserve to its policyholders on the pledge to it of their policies and any accumulations thereon."

Kentucky here got the same credit for its liens as it did for sums advanced to borrowers under the above statute.

The evidence in this case showed that the interest paid or accrued upon the liens in question was treated in Kentucky's statement of assets and liabilities in the same manner and with the same effect as interest received upon loans made to its policy holders. It qualified this admission by saying that interest received on liens and interest received on loans was treated "mechanically" the same. However, it did not point out where there was any difference in substance.

Kentucky further argues that the interest in question should be treated as in the nature of premium payments because as such interest was paid it increased the amount of insurance that would ultimately be payable to policy holders. However, the full premium payable upon each insurance contract was paid by the policy holder in addition to the interest charges upon the lien. It is true that by paying the interest on the lien currently the policy holder would increase the amount that would be payable upon maturity of the policy. Such, indeed, is the consequence, always, where a mortgagor or lienor pays the interest on a mortgage or lien. The payment of such interest protects the equity value of such asset subject to the lien or mortgage.

Interest has been defined as, "the compensation allowed by law, or fixed by the parties, for the use, detention, or forbearance of money or its equivalent." 30 Am. Jur., Interest, Sec. 2. We are of the opinion that the interest received by Kentucky on these liens came *substantially* within such definition. Such interest was required to be paid by the policy holders if they desired to maintain the liens in status quo. By submitting to liability for such interest, they obtained forbearance from the necessity of paying up the liens prior to settlement on the policies. By electing to continue their policies in force, they became parties to the re-insurance agreement which fixed their

liability for such interest. As stated in the taxpayer's brief, "under the law of Kentucky, . . . the Insurance Department speaks and acts for every policyholder." *Kentucky Home Mutual Life Insurance Company* v. *Leitner*, 302 Ky. 739, 196 S. W. (2d) 421; *Grimes* v. *Central Life Insurance Company*, 172 Ky. 18, 188 S. W. 901; *Breckinridge* v. *Kentucky Central Life & Accident Insurance Company*, 206 Ky. 244, 267 S. W. 178.

The question involved here does not appear to have been involved in any previous litigation, and we have no regulations, opinions of the Revenue Department, or decided cases to guide us. We, however, are of the opinion that the interest upon which the tax involved here was imposed was what it was called by all parties involved—interest—and was, therefore, subject to income tax as provided by the applicable statute.

The judgment of the District Court is reversed, with direction that judgment be entered in favor of the United States.

CECIL, Circuit Judge, Concurring.

I concur in the opinion of Judge O'Sullivan.

A legal reserve life insurance company is required by law to maintain a reserve fund for the protection of its policy holders. This fund is made up of a portion of the current premiums and the income from the investments in the reserve. The amount of this reserve is fixed by law. It is intended that if a policy holder lives out his expectancy, there will be sufficient assets in this reserve against his policy to pay the face of the policy. When a policy holder does not live out his expectancy, the amount of the face of the policy, over and above the reserve against it, is paid from other funds of the company, sometimes called a mortality fund.

When a policy is terminated either by a death claim or through accepting the cash surrender value, or when a loan is made against that policy, the insurance company may draw down the amount of the reserve and put it in the general funds or some special fund of the company.

As a part of the reinsurance agreement in this case, the insurance commissioner required that Kentucky Mutual set up the reserve in the full amount required by law. Since the assets of Southern were sixty percent short, there was placed against each policy a lien equal to sixty percent of the net equity of such policy. It was provided in the first agreement that this lien should be increased at the rate of six percent per year compounded annually. An amended contract with which we are now concerned fixed this interest rate at five percent.

A policy holder could pay off this lien in full or pay it off partially, or pay the annual interest. If he made no payments, the lien was increased by the annual interest additions, at compound interest.

In the year with which we are concerned, in the settlement of a policy either by cash surrender or payment of a death claim, the Kentucky Mutual was entitled to deduct the amount of this lien plus any accumulated interest from the amount owed the policy holder.

Assume, for example, that in the taxable year in question the five-percent interest provided in the contract on the lien in a certain policy amounted to $300. If the policy holder did not pay that during the year, Kentucky could add that amount to the total of the then existing lien. It could then have drawn down $300 from the actual reserve on deposit with the Commissioner. This sum could be mingled with its other funds and would be free or unrestricted of any requirement of the reserve. If at the end of the year the policy holder chose to take the cash surrender value of his policy he would get $300 less than he

would have received before the accumulated interest was added. The same is true if it had matured as a death claim. The beneficiary would receive $300 less after the accumulated interest was added.

If the policy holder had paid the $300 interest, the amount of the lien would have remained the same and the relationship between the reserve on deposit and the lien would have been maintained. This would have been $300 in the unrestricted funds of Kentucky Mutual.

In either case, whether the $300 is paid or not, the Company has received that amount of income. In reality the five-percent interest provided by the contract was in lieu of the income the company would have earned on its investments if the sixty percent represented by the lien had actually been in the reserve. The income on the investments of the reserve must be included in gross income under Section 201(c) 1, Title 26 U. S. C., Internal Revenue Code of 1939. An insurance company is, however, allowed a credit on this reserve. The entire net income of an insurance company is taxable subject to a formula provided by Section 202 of the above act. See examples under Section 39.202-1(a) (b) Federal Tax Regulations of 1956. (Applicable to the 1952 taxable year.)

It is argued for the taxpayer that it performed its agreement with the insurance commissioner and that it received nothing but what was provided in the contract. This is true but I find nothing inconsistent with the taxpayer making an income on some provision of the contract. The government was not a party to the contract.

McAllister and O'Sullivan, Circuit Judges.

We also concur in the opinion of Judge Cecil.

APPENDIX C.

JUDGMENT ENTERED JULY 11, 1961 BY THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

APPEAL from the United States District Court for the Western District of Kentucky.

THIS CAUSE came on to be heard on the transcript of the record from the United States District Court for the Western District of Kentucky, and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be and the same is hereby reversed, and the cause remanded to the District Court with direction that judgment be entered in favor of the United States.

Approved for Entry:

/s/ Clifford O'Sullivan,
United States Circuit Judge.

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JOHN F. DAVIS, CLERK

No. 657

In the Supreme Court of the United States

OCTOBER TERM, 1961

KENTUCKY HOME MUTUAL LIFE INSURANCE COMPANY,
PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The question in this case is whether the court below erred in holding that the taxpayer realized interest income under Section 201(c)(1) of the Internal Revenue Code of 1939 (26 U.S.C. 1952 ed., Sec. 201) when it received, partly in cash and partly through deductions on insurance policy settlements, the accrued interest for which provision was made in a reinsurance agreement executed in 1932. Under this reinsurance agreement, which was authorized by court order, the taxpayer took over the assets of the insolvent Inter-Southern Life Insurance Company and reinsured its policies (Pet. App. 30–31). Because Inter-Southern's reserves were impaired, the reinsurance agreement

imposed a lien, to bear interest at 6 percent, on the 1932 reserve on each policy to the extent of 60 percent of the net equity on the policy (Pet. App. 31–33). A policyholder was entitled to pay off the lien and interest at any time, but, if he did not do so, any unpaid balance was to be subtracted from any payment he thereafter received as a policyholder (Pet. App. 33–34). In the taxable year (1952), the taxpayer received $6,731.36 in cash as accumulated interest on the liens on the policies and, in addition, set off $61,271.28 in accumulated interest in connection with policy settlements (Pet. App. 34).

1. Taxpayer argues that the interest payments were not paid for the use of borrowed money and therefore were not true "interest" (Pet. 9–12) and that the taxpayer realized no economic benefit from the interest payments (Pet. 12–18). But, as the court below concluded (Pet. App. 39–40), the situation here is, in substance, indistinguishable from one where a policyholder secures a loan from the insurance company against his policy. Under the reinsurance agreement the taxpayer took over Inter-Southern's insurance policies (as well as its assets) without changing the policies in any way except to impose a 60 percent lien on each policy, the amount of which, plus interest thereon, would be subtracted from the amount payable to the policyholder on a settlement unless the policyholder had previously paid off the lien and interest. The result was to increase the cost to the policyholder of full coverage under his policy and to create an obligation for the payment of cash to the

taxpayer, which was accepted by all policyholders who continued their policies in effect by paying the original, regular premium. The impact of the lien was therefore no different than if the policyholder had previously paid the full cost of full coverage under the policy (the regular premiums plus the amount of the lien) and then borrowed the amount of the lien from the insurance company. Indeed, in considering the very reinsurance agreement involved here, the Court of Appeals of Kentucky has stated that "[t]he substantial effect of this agreement, of course," was to place "a loan against each policy * * *." *Kentucky Home Life Insurance Co.* v. *Leisman*, 268 Ky. 825, 828–829, 105 S.W. 2d 1046, 1047; see *Carrington* v. *Kentucky Home Mut. Life Insurance Co.*, 61 F. Supp. 424, 427 (W.D. Ky.). The economic benefit to the taxpayer is obvious, since the amount of the lien obligation, if not paid, was the amount by which the taxpayer's settlement obligations under the policy were reduced.

2. The taxpayer's other contentions (Pet. 12–26) are also without merit. The court below considered the substance of the transaction, instead of ignoring it, as the taxpayer asserts. Since the accrued interest, which the taxpayer received in cash or deducted in policy settlements in the taxable year, clearly constituted interest income to the taxpayer, both in substance and in form, the court below did not exceed the scope of its authority under the "clearly erroneous" rule in reversing the district court's finding to the contrary.

The decision below is correct; no conflict of decisions or important question is involved. The petition for a writ of certiorari should therefore be denied.

Respectfully submitted.

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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1961

No. 657

KENTUCKY HOME MUTUAL LIFE INSURANCE COMPANY, - - - Petitioner,

versus

UNITED STATES OF AMERICA, - - Respondent.

REPLY BRIEF IN SUPPORT OF PETITION FOR CERTIORARI.

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INDEX

PAGE

Argument in reply to Brief in Opposition 1

CITATIONS

Cases:

PAGE

Carrington v. *Kentucky Home Mutual Life Insurance Co.*, 61 F. Supp. 424 (W. D. Ky., 1945) 2

Equitable Life Assurance Society v. *United States*, 181 F. Supp. 241 (Ct. Cl., 1960; opinion by Reed, J., Ret.), cert. den. 364 U. S. 829 (1960) 12

Kentucky Home Life Insurance Co. v. *Leisman*, 268 Ky. 825, 105 S. W. 2d 1046 (1937) 1, 2

Kentucky Home Mutual Life Insurance Co. v. *Leitner*, 302 Ky. 789, 196 S. W. 2d 421 (1946) 11

Statutes:

Internal Revenue Code of 1939 (26 U.S.C., 1952 ed.):

§ 22(a) 12

§ 201(c)(1) 12

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UNITED STATES OF AMERICA, - - - *Respondent.*

REPLY BRIEF IN SUPPORT OF PETITION FOR CERTIORARI.

The respondent's Memorandum in Opposition calls for a short reply.

First: The respondent is incorrect in attributing to us the view that the Court of Appeals erred in "ignoring" the substance of the transaction. We say rather that the Court's two opinions clearly and affirmatively show that it has wholly *misconceived* the substance of the transaction. What it has *ignored* is the special statutory definition of life insurance company income.

Second: The two cases cited by respondent, if pertinent at all, support our position rather than respondent's. In *Kentucky Home Life Insurance Co. v.*

Leisman, 268 Ky. 825, 105 S. W. 2d 1046 (1937), and in *Carrington* v. *Kentucky Home Mutual Life Insurance Co.*, 61 F. Supp. 424 (W. D. Ky., 1945), the question was whether the 1932 reinsurance agreement (and, in the latter case, the 1939 amendment) were effective, as between the company and its policyholders, in limiting Kentucky's *reinsurance* obligation to an amount less than the *original* obligation of Inter-Southern. In both cases an affirmative answer was given, the court making very plain the difference between the two separate obligations. In the *Leisman* case the Court specifically pointed out (105 S. W. 2d at p. 1048):

> "This argument [of appellee] ignores the fact that the policy was amended by the reinsurance agreement, and the liability of the appellant must be predicated on what it assumed to do under its contract. Appellee is not seeking to hold the Inter-Southern Life Insurance Company on the policy, but to hold its reinsurer. Casteel v. Kentucky Home Life Insurance Company, 258 Ky. 304, 79 S. W. 2d 941."

In neither case did the Court characterize the annual adjustments of policy impairment as interest—much less as interest subject to taxation as life insurance company income. The Kentucky Court of Appeals analogized the so-called lien to "a charge or loan against all of the policies" (105 S. W. 2d at p. 1048) in explaining that the amounts due to the beneficiaries of Inter-Southern policies were *the same as if* the policyholders had made 60% policy loans on June 30, 1932—a proposition which has nothing to do with the

present case. But this is a far cry from saying that policy loans *were* made, or that the income tax consequences are the same as if they *had been* made.

Third: We had thought it unnecessary, in view of the settled rule that the incidence of income taxes depends not on the parties' verbal characterization but on the substance of their transaction (Petition for Certiorari, pp. 20-24), to explain why the reinsurance agreement used the terms "lien" and "interest" in a technically inaccurate manner. But the respondent's failure to respond to our claim that the annual adjustments were not "interest"—except to labor the obvious fact that (for reasons explained at pages 6-7 of the Petition for Certiorari) the *amounts* of the adjustments increased year by year—suggests that it is appropriate to show how the terms "lien" and "interest" came to be used in the reinsurance agreement. A few pages of history (which, as usual, are worth volumes of logic) will suffice to show that the use of these terms in the agreement cannot possibly be regarded as a conscious recognition or concession that "interest" adjustments or payments would constitute interest income within the meaning of the Internal Revenue Code.

The general pattern of the 1932 reinsurance agreement, which established the basic legal relationships here involved, was simple enough. Kentucky, then newly organized, agreed to take over Inter-Southern's assets and to assume Inter-Southern's liabilities, including obligations on its outstanding policies, *to the*

extent that it could expect to carry them by use of assets thus received.

However, because of the complexities of the insurance business and the diverse provisions of Inter-Southern's several types of policies, a detailed and complex contract was needed to implement this simple objective. Still further complexity was occasioned by the uncertainty of the parties as to how much Inter-Southern's assets would ultimately prove to be worth, and the additional uncertainty—implicit in any insurance business—as to how much the claims on policies would eventually turn out to be.

These problems were met in the following manner: Estimated valuations were arbitrarily assigned to the Inter-Southern assets. On the basis of these valuations, and on assumptions as to its liabilities, the impairment of the equity of its existing policyholders was tentatively estimated at 60% of the reserve on their respective policies as of June 30, 1932. On each Inter-Southern policy Kentucky therefore tentatively limited its reinsurance obligation, so far as policy loans and pre-death cash settlements were concerned, to the amounts guaranteed by Inter-Southern *less 60% of the reserve on the respective policy as of June 30, 1932*—except that this 60% reduction was not at that time made applicable to death claims (Pars. 4 and 5) (R. 15-17; App'x 11a-13a).

In recognition of the possibility that the assumption as to the value of Inter-Southern's net assets might prove to be too high, provision was made for

subsequent increase of the 60% figure in the light of later experience (Pars. 15, 16, 18, 28) (R. 24-27, 31-32; App'x 20a-22a, 27a-28a). And in order that the Inter-Southern policyholders rather than Kentucky might get the benefit of any profit which might result from favorable developments with respect to the value of Inter-Southern's assets or the mortality experience under its policies, Kentucky agreed to keep its accounts on the reinsured business separate from its accounts on new business of its own, and to apply any profits on the Inter-Southern business for a period of about twenty years—specifically, until the end of 1952—to reduce the 60% impairment of the Inter-Southern policies (Pars. 19-25) (R. 27-30; App'x 23a-26a).

In substance, the 1932 reinsurance agreement thus established an arrangement much resembling an extra-judicial receivership for Inter-Southern's assets and business, whereby Kentucky would administer its affairs—receiving no profit thereon until the end of 1952 or until the Inter-Southern policies had been restored to full value, whichever should be earlier.*

In order to give practical effect to these provisions, in terms which could be understood not only by the contracting parties but by the thousands of policy-

*It will be noted that under these circumstances it made little if any difference to Kentucky whether the Inter-Southern assets were more than sufficient to carry its policy obligations, reduced as described above. If the arbitrary asset valuations proved to be too low, or if mortality experience was unexpectedly favorable, or if other unexpected gains resulted from the old Inter-Southern policies, the resulting profit would not benefit Kentucky but would be applied to reduce the 60% impairment of the policies (Par. 20) (R. 27; App'x 23a).

holders whose rights against Inter-Southern were to receive less than full recognition, it was appropriate and indeed necessary to couch the agreement—complex at best—in language as simple and familiar as possible. It was also highly desirable to utilize concepts sufficiently in keeping with the mass accounting methods necessarily used in insurance operations, so that the accounts of Inter-Southern policyholders *vis-a-vis* Kentucky could be simplified as much as possible and integrated with Kentucky's over-all accounting system, covering its own future policies as well as the reinsured Inter-Southern policies. For that reason the reinsurance agreement described the 60% burden on Inter-Southern policies as a *lien*, thereby analogizing it to the familiar concept of a policy loan. In effect, each Inter-Southern policyholder was told that his policy was impaired to the same extent as if he had borrowed, on August 8, 1932, 60% of its June 30, 1932 cash value.

A reading of the reinsurance agreement makes it perfectly clear that no lien, properly so called, was created. The relationship of the policyholder with Inter-Southern and with Kentucky was a contractual relationship. As between the parties, Kentucky had only the duty (conditioned on receipt of stated premium payments from the policyholder) to lend or pay him certain stipulated amounts upon the happening of stipulated events. The insurer's said obligation was wholly unsecured (except to the extent of statutory deposits made with the Insurance Department, which have no bearing on the present discussion).

As stated by Judge O'Sullivan below (R. 148):

> "A lien is a charge or encumbrance upon property *to secure the payment or performance of a debt,* duty, or other obligation. *United States* v. *Phillips,* 267 F. 2d 374, 377 (C. A. 5, 1959)." (Emphasis added.)

The existence or non-existence of a lien has no effect on the position of debtor and creditor *inter sese;* its only effect is to give the creditor a preferred position as against other creditors. But the so-called "lien" provided by the 1932 reinsurance agreement did not do this. Its only effect was to provide the measure of Kentucky's reinsurance obligation to Inter-Southern policyholders.

As a matter of fact, the term "lien", as used in the reinsurance agreement, was a solecism on its face: for a lien is nothing but a security device ancillary to a principal obligation. No one can sue on a lien as such, where a principal obligation does not exist. And there was no such principal obligation on the part of the Inter-Southern policyholders. They were not *indebted* to Kentucky for their share of the 60% impairment; their policies were non-assessable.

By applying the term "lien" to the 60% policy impairment, and thereby analogizing it to a policy loan, the 1932 reinsurance agreement not only made it understandable to policyholders and manageable by bookkeepers; it also automatically accomplished a further business purpose which, though less important, was nevertheless of material value both to the policy-

holders and to Kentucky: *The policyholder was in effect told that he could restore his policy to its face value by paying off the "lien" in cash.* He was thus enabled to get from Kentucky what he had originally bargained to receive from Inter-Southern, by paying his pro-rata part of Inter-Southern's impairment.

From Kentucky's viewpoint, such cash payments were of course welcome; for the 1932 reinsurance agreement clearly and repeatedly reflects the cash stringency which faced Kentucky at this incipient stage—the rights of Inter-Southern policyholders to demand cash being postponed for periods ranging from four months to three years, depending on the nature of their claims (Pars. 7, 9, 10, 11) (R. 18-22; App'x 14a-18a).

Moreover, it must be kept in mind that a policy reserve is not a static thing. It must grow with the policy. Ordinarily the means of growth is provided by investment income from the reserve assets. But where, as here, 60% of the reserve is represented by a book entry only, other provision for the necessary increase must be made. Otherwise the reserve would automatically become inadequate as the policies grew older and the reserve requirements increased.

These problems were met by means of a provision that, unless the "liens" were discharged by a cash payment, they would increase by 6% a year, compounded annually. In this way provision was made for continued adequacy of the depleted reserve assets; policyholders were given a mild incentive to put in Kentucky's hands cash which it sorely needed; and policy-

holders who elected not to do so were mildly penalized by annual reduction of the cash and loan value of their policies—a reduction which, in itself, tended to mitigate Kentucky's cash problem.

The same considerations of comprehensibility and accounting convenience as had led to the use of the term "lien" likewise suggested that the annual increase in unpaid "liens" be called "interest." Of course the increase was not actually interest; for, as Judge O'Sullivan has at least verbally recognized in his opinion below (R. 149):

> "Interest has been defined as 'the compensation allowed by law, or fixed by the parties, for the use, detention, or forbearance of money or its equivalent.' 30 Am. Jur., Interest, Sec. 2."

Payments or adjustments in Kentucky's favor by reason of the "interest" adjustments would not represent compensation for the use, detention or forbearance of money; for Kentucky had not lent the policyholder anything, and the policyholder owed Kentucky no debt on which forbearance could be granted. All Kentucky had done was to stipulate for an annual increase in the "lien" unless and until it were either paid off, or offset in a pre-death settlement, or written off in a death settlement.

As of August 8, 1932, the parties can hardly be criticized for using the terms "lien" and "interest". The terms served their business purposes well. The policyholders were thereby informed of their legal position in understandable language, and Kentucky

was enabled to handle its bookkeeping on a manageable basis. No deceit was practiced, and no advantage gained.

Actually, it is hard to devise any simple terms which, from the viewpoint of business realities, will describe the policy impairment and its annual adjustment as well as the terms actually used. Proof of this can be drawn from our own certiorari petition. For in order to keep the legal issues unclouded we there avoided use of the controversial terms wherever possible; and the Court must have noted the awkwardness of expression which necessarily resulted.

Kentucky could hardly have anticipated that, nearly a quarter of a century after 1932, a future generation of tax gatherers would appear with their magnifying lenses, their dictionaries and their blinders, and belabor Kentucky's departures from their own standards of literary purism.* It cannot be said that the use of the terms "lien" and "interest" involved any conscious acknowledgment that the "interest" payments and credits would be taxable, or that the characterizations employed in the reinsurance agreement were expected to have any more effect on the incidence of income tax than they had on the business relations involved.

The 1935 and 1939 amendments to the 1932 reinsurance agreement did not change the character of the "lien" and "interest" originally provided for. On March 16, 1935, the agreement was revised in a number of respects, the main changes being designed (a) to

*Despite full disclosure by Kentucky in each year, the present question was not raised until the 1952 return was audited in 1954.

take account of the fact that Kentucky was becoming a mutual company; (b) to eliminate the provision for separate accounts on the old Inter-Southern policies; and (c) to leave it to Kentucky to decide whether profits on the Inter-Southern business would be applied to reduce the "liens". The judicial receivership was terminated at that time.

The agreement was further revised on September 18, 1939. The only change relating to "lien" and "interest" was that the "interest" rate was reduced to 5% and the "lien" was made applicable to death claims as well as to loans and pre-death cash settlements.

The record does not disclose in detail the business considerations which led to the two revisions of the original agreement. It can fairly be inferred from the instruments themselves, however, that the changes reflected developments in Kentucky's business position, and embodied the results of negotiations in which the Insurance Commissioner was performing his official duty to protect the interests of the Inter-Southern policyholders by seeking changes mutually advantageous to them and to Kentucky.*

Each revision carried forward the terms "lien" and "interest" with the same meaning and contractual effect as in the 1932 agreement. Indeed, it could hardly

*The circumstances which led to the two amendments are recited in *Kentucky Home Mutual Life Insurance Co.* v. *Leitner*, 302 Ky. 789, 196 S. W. 2d 421 (1946), where it is noted that the necessity of charging the "lien" against death claims from and after September 18, 1939, resulted from the worthlessness of an Inter-Southern asset which, in 1932, had been valued at $2,200,750.

have been otherwise; for the business objectives which had led to use of those embattled terms by the parties to the 1932 reinsurance agreement were still important in 1935 and 1939.

We submit that the legal character of the "interest" payments and deductions here involved was initially fixed by the 1932 reinsurance agreement; that nothing in the later amendments can rightly be thought to have altered their character; and that the taxpayer is entitled to have its rights determined in accordance with the substance of its business arrangements, thus revealed, rather than on superficial verbal grounds.

When the shoe is on the other foot, the tax authorities are quick enough to treat as interest any payment received for the use of money, no matter what it is called. See, in addition to cases already cited, *Equitable Life Assurance Society* v. *United States*, 181 F. Supp. 241 (Ct. Cl., 1960; opinion by Reed, J., Ret.), cert. denied 364 U. S. 829 (1960) (loan prepayment penalties *held* taxable as interest). There is no room for a double standard.

In closing, we point out that respondent has evidently failed to grasp the meaning of our contention that the payments and adjustments in question not only did not constitute *interest*, in the accepted meaning of the term; not only did not constitute *life insurance company income* within the carefully limited definition prescribed by §201(*c*)(1) of the Internal Revenue Code of 1939; but would not even have been taxable as income pursuant to the "economic benefit" test which has been developed under §22(a), defining

"income" for taxpayers other than life insurance companies. As shown by our petition for certiorari (pp. 12-14), it is inconceivable that Kentucky realized any economic benefit in the settlement of Inter-Southern policies by deducting the so-called lien and accumulated interest, since that is the exact formula prescribed by the reinsurance agreement for determining Kentucky's liability under that instrument.

For the foregoing reasons, and for the reasons stated in the petition, certiorari should be granted.

Respectfully submitted,

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